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The Grand Liquidity Illusion

> **"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of the casino, the job is likely to be ill-done."**
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> **The General Theory of Employment, Interest and Money**
> **John Maynard Keynes, 1936**

Storm clouds have appeared abruptly over the global financial markets in the form of a weakening dollar and an abrupt reversal of the bull run in bonds. While this unwelcome news has not yet punctured the speculative euphoria on Wall Street, the omens are hardly favorable. Higher bond yields, combined with fading economic growth, certainly can not be considered a constructive scenario for equity investors.

The source of these woes is all too familiar. Once again, monetary uncertainty has pricked a speculative bubble in bonds fueled by cheap, borrowed money. As in 1994, the leveraged carry-trade players are on the run, scrambling to unwind their huge positions before the market moves against them even more.

But the present dangers are even greater than in 1994, the year of the biggest bond bear market in history. In their reckless attempt to exploit the yawning gap between Japanese short-term rates and bond yields in the United States and elsewhere, the international speculators have added a new element of risk – currency risk – to their carry-trade game. As a result, a repeat of last year's dollar collapse could spell instant disaster for global markets.

To save them from their own folly, the international speculators look to the central banks. Surely, they say, the threat of global recession, combined with stable or falling rates of consumer and commodity price inflation, will elicit further cuts in short-term rates. Surely the Bank of Japan will move heaven and earth to stem the dollar's decline.

We find it hard to quarrel with those assessments. Desperate to stave off an election-year recession they never saw coming, Federal Reserve chairman Alan Greenspan and his colleagues do appear poised for a round of sharp rate cuts. The BoJ already is buying dollars at a record pace to defend the greenback at current levels. These expedients may yet buy more time for the great financial bubble.

But contradictions within the speculative camp pose their own threat. Steeped in American monetarist orthodoxy, one faction frets that rampant central bank easing ultimately will fuel wage and commodity price inflation, as oceans of excess liquidity spill from financial assets into the markets for goods and services. Those fears clearly contributed to the recent rise in the gold price, which did much to trigger the stampede out of bonds.

In this issue, we return to this question of liquidity, which we have addressed in so many of our past letters. Our conclusion is clear and urgent: There is no tidal wave of liquidity poised to inundate the real economies. The proof lies in the sluggish growth of monetary aggregates worldwide, and particularly in the United States and Japan.

In the last analysis, only money – that is, bank deposits – can be considered truly liquid. The frenetic circulation of existing cash balances, which has driven financial asset prices to such absurd heights, may create the illusion of liquidity. But that appearance, and the bull market itself, will vanish once the flight from cash reverses itself. The inevitable result: asset deflation, not commodity inflation. This is the real threat facing the markets and economies.

THE PICTURE DARKENS

Entering 1996, world financial markets were bursting with euphoria. All signs pointed to further gains in stock and bond prices, given weakening economies, falling inflation rates and the sure prospect of still more rate cuts by central banks. Judging by the conventional gauges of consensus opinion, the outlook couldn't have been more bullish.

In the last analysis, this euphoria was crucially conditioned on the assumption that inflation rates are the most important fundamental for the bond markets. According to popular perception, declining inflation is directly bullish for bonds because it increases yields in real terms. It also is indirectly bullish because it usually is accompanied by monetary easing and rate cuts by central banks.

Since this is the dominant thinking in the markets, it must be taken into consideration, even if one disagrees with the whole concept. Nevertheless, this supposed interest-rate "theory" is all too simplistic and grossly flawed. The critical fallacy is its complete disregard of the paramount question: What are the exact sources of the money flowing into the markets? Following classical theory, the decisive distinction is between money that springs from current savings, and money flowing from the various sorts of inflationary processes that finance short-term speculation.

The U.S. bond market mania of 1993 was overwhelmingly fueled by an unusually steep yield curve. The 3% short-term rate, imposed by the Federal Reserve, was barely enough to cover the going inflation rate. This triggered two unusual financial flows. One was a mass flight of investors out of low-yielding bank balances and into securities. The other was a bout of speculative yield-curve playing on a completely unprecedented scale.

Borrowing at cheap short-term rates, banks and speculators lent long to the U.S. government, in the form of medium or long-term bonds then yielding around 6%. While Wall Street analysts raved about the excellent economic fundamentals driving the rally, it actually was a clear case of a speculative bubble, which promptly burst once the Fed began raising short-term rates in February 1994.

What about the 1995-96 bull run of world bond markets, again led by Wall Street? In the consensus view, it also had a solid base in extremely positive underlying conditions, such as moderate economic growth, if not recession, in Europe and the United States. This, in turn, virtually guaranteed declining inflation pressures and weakening cyclical credit demand, compelling the Fed and other central banks to adopt a course of further monetary easing. For the consensus, again, it looked like the perfect prescription for new lows in bond yields in the global financial village.

By mid-February, indeed, yields in most markets did hit new lows. But then, in a development that stunned investment pros, bond yields abruptly backed up around the world – even though the economic and inflation news continued to appear intrinsically bullish. No less cryptic and ominous was the sudden, mysterious surge in the dollar gold price. The Comex lead futures contract settled briefly at a peak of $417.70, its highest level since the run up in the aftermath of the Iraqi invasion of Kuwait in 1990.

As both the sell-off in bonds and the gold rally seemed to come out of the blue, all kinds of reasons have been trotted out to explain (or explain away) these two big surprises. While some analysts have cited specific, technical factors behind the big gold rally, most analysts seem to see one common, main influence driving the opposite movements of bond prices and the gold price. The concerted efforts of central banks in all of the industrialized countries to reflate their flagging economies, we are told, implies an inexorably expanding supply of dollars, yen, marks, francs, etc. sloshing around in the world markets.

Basically, this reasoning is very much in line with the often-voiced view that the recent global bull run in financial assets has had its chief driving force in a surfeit of liquidity resulting from excessive easing by the central banks. All along, it has been a popular perception that this "excess liquidity" eventually would spill over into the real economy, and finally into commodity and consumer price inflation. Given that assumption, it appears logical that the gold price – so acutely sensitive to inflation fears – would be the first to respond.

Global Capital Market Trends

Equities
Selected Markets, % Change

Country (February 27)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	2.1%	2.8%	19.6%	-1.6%	21.2%
Canada	1.1%	5.1%	21.0%	-2.1%	21.4%
France	0.4%	5.5%	9.6%	-2.4%	14.7%
Germany	0.5%	8.5%	16.5%	-1.0%	27.9%
Hong Kong	0.8%	11.2%	37.8%	-3.4%	41.2%
Japan	-3.2%	0.7%	19.0%	-5.3%	38.1%
Mexico	-4.6%	5.8%	103.0%	-5.3%	103.0%
Spain	3.7%	6.3%	28.1%	-0.1%	34.7%
U.K.	-0.5%	0.7%	22.8%	-1.7%	24.8%
U.S.	4.1%	5.1%	33.8%	-2.1%	34.2%

Ten-Year Bond Yields
Selected Markets, Basis Point Change

Country (February 27)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	8.69	68	42	-137	-168	72
Canada	7.54	43	46	-106	-136	60
France	6.72	33	8	-123	-158	45
Germany	6.45	55	42	-87	-101	65
Japan	3.52	40	45	-85	-87	92
Spain	9.74	11	4	-210	-282	48
U.K.	7.94	50	53	-69	-86	71
U.S.	6.07	43	50	-115	-136	54

Exchange Rates
Versus U.S. Dollar, % Change

Country (February 27)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.32	2.9%	2.2%	2.5%	-1.5%	6.7%
Canada ($)	1.38	0.5%	-1.0%	0.9%	-3.4%	2.9%
France (*f*)	4.99	2.9%	-2.1%	3.4%	-4.8%	3.4%
Germany (DM)	1.45	2.5%	-1.1%	1.0%	-7.4%	2.7%
Japan (¥)	104.38	2.1%	-0.9%	-7.5%	-29.5%	2.8%
Spain (Pt)	121.79	3.6%	-0.3%	5.2%	-3.0%	0.0%
U.K. (£)	1.54	2.5%	-0.7%	-2.5%	-6.0%	2.5%

LEVERAGE VERSUS LIQUIDITY

All along, we have been in flagrant disagreement with Wall Street's liquidity story. The assertion that the global financial boom of recent years has been "liquidity-driven" flies blatantly in the face of the observable monetary facts. In the major countries, and in particular the United States, measurable liquidity is sharply down. That is the main reason we are so wary of this protracted boom. What we see is not excess liquidity but rather excess leveraging and excess borrowing for speculative purposes.

Our argument essentially begins with the question: How does one define and measure liquidity, and specifically "excess liquidity"? Admittedly, liquidity is an elusive concept. Even if one decides which assets should be granted the label of liquid, it doesn't follow that adding up their value will tell us how liquid the community feels. Given the financial boom, owners of bonds and stocks undoubtedly *feel* highly liquid. But this is conditioned upon the boom. Once it stops, or reverses, the perception of abundant liquidity will simply vanish.

Strictly speaking, truly liquid assets are those that can, under any circumstances, instantly be turned into cash without any delay or loss. That quality, however, is confined to a single kind of asset: bank deposits. The reason – and this is fundamental – is that deposits serve as a means of payment. They need no conversion into money; they *are* money. Since prices of all marketable assets are subject to fluctuation, they can never be regarded as completely liquid. In short, only the existing money stock is 100 percent liquid.

So much for the definition of liquidity. Next we turn to its measurement. How does one tell whether the liquidity of the U.S. economy – or any other economy for that matter – is rising or falling? That, too, is not difficult. The regular and appropriate way to measure the liquidity of an economy is to compare the growth of the money stock with the simultaneous growth of other aggregates, such as the national product, nonfinancial debt, or the total value of assets. This provides us with different liquidity ratios.

The terms "excess liquidity," and "liquidity-driven" first became popular on Wall Street in the 1980s. They reflected the fact that nominal broad-money growth persistently exceeded nominal GDP growth throughout much of that period. The notion was that this excess liquidity essentially had no other outlet than the financial asset markets. In that particular case, it mainly poured into bonds and stocks. Simply put, the idea was that bull markets develop when money growth exceeds GDP growth.

CASH IS TRASH – FOR NOW

Now we turn to the facts: Between 1985 and 1990, cumulative U.S. broad money growth (M2) of 40.6% corresponded to cumulative nominal GDP growth of 36.5%. Overall liquidity, as measured by the broad money stock, rose modestly faster than overall economic activity, as measured by nominal GDP.

But the important new point to see is that throughout the 1990s this ratio of the money stock to GDP has dramatically deteriorated. While nominal GDP has grown 27% in this decade, broad money has risen just 12%, resulting in the worst money-to-GDP ratio of all time. Worse, no less than three-quarters of all money growth has been in cash in circulation, most of which ends up in black markets outside the United States.

By the three measures shown here, the U.S. economy's liquidity has drastically deteriorated. This makes complete nonsense of the prevailing perception that the financial boom is being driven by excess liquidity. In reality, the booming markets have been concealing a progressive liquidity squeeze. Every inflation breeds illiquidity. Asset inflation is no exception.

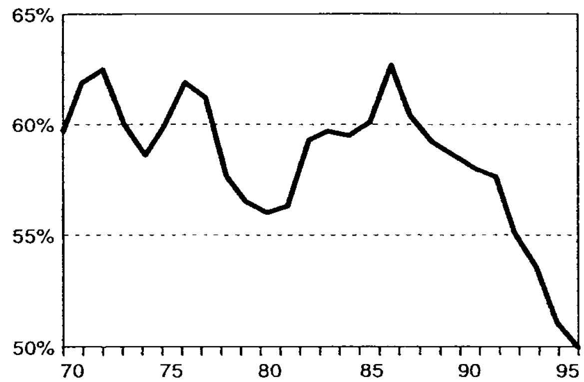
So where has the money swamping and buoying global financial markets come from, if not from excess liquidity? It definitely hasn't come from current savings, despite some recent, absurd suggestions to that effect by Wall Street analysts.

Overwhelmingly, the torrent of money pouring into the securities markets has had two, ambiguous, inflationary sources. One is heavy borrowing and leveraging; the other is a massive activation of the vast pool of the existing world money stock in national and international markets – in other words, the famous dash from cash. An important point to see in this context is that most of these transactions do not result in the creation of new money, but rather in an increase in money velocity.

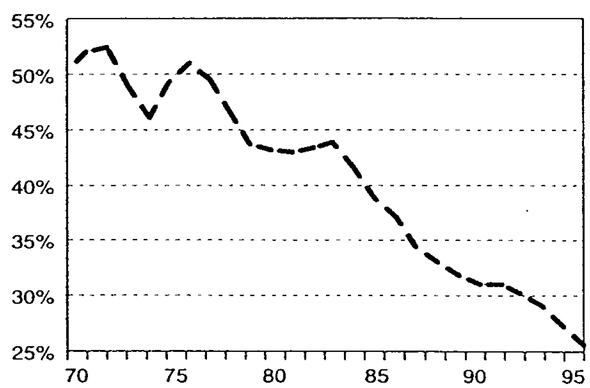
As we have repeatedly explained in past letters, banks alone possess the capacity to create money. This is due to the fact that their liabilities – in the form of customer deposits – are a means of payment. As they expand their loans or investments, their liabilities rise in tandem.

The Death of Liquidity

M2 as a Percentage of Nominal GDP



M2 as a Percentage of Private Debt



Money Holdings of U.S. Individuals
As a % of Total Financial Assets

Source: Federal Reserve

WHAT NEXT: REFLATION OR COLLAPSE?

At this juncture, one question above all troubles the markets: How quickly will the global reflation being engineered by the major central banks restimulate economic growth? Most commentators put the start of the expected recovery in the second half of this year. Underlying this forecast are two assumptions: First, that the central banks are desperate to reflate; secondly, that the industrialized economies are highly responsive to such monetary easing. Indeed, some analysts warn that reflation already has gone too far, threatening the return of commodity and consumer-price inflation.

We strongly disagree on every point. Our argument starts with the observation that the central banks in reality have been rather slow to cut interest rates. In any case, the monetary and credit aggregates so far reflect no visible expansionary effects. In Japan, the United States and Germany, in particular, these indicators all show pronounced weakness. Before we see reflating economies, we need to see reflating credit and money flows. Only three countries – Britain, Australia and Spain – currently show strong broad money growth (averaging around 9% at annual rates).

In the United States, broad money and credit growth, far from showing any acceleration, has displayed a steep descent in recent months. M2 and M3 growth has slowed from 7-8% last autumn to 2.5% and 2.6%, respectively, in the last three months. Whatever this abrupt, sudden downturn in the U.S. monetary aggregates may mirror, it definitely is not effective reflation.

The other country that plays a key role in the global bull story is Japan. Obviously, there is a widespread prejudice on the part of analysts which holds that the Bank of Japan, desperate to revive the weak Japanese economy and depress the strong yen, has thrown its money spigots wide open. But examining the balance sheets of the BoJ and the Japanese banking system, we still don't see signs of meaningful monetary expansion. What stands out is a double-digit rise in Japanese narrow money (M1). This is widely cited as a proof of an ongoing, strong monetary expansion. But considering that currency in circulation is an important component of this rise, we don't see much significance to it.

Again and again in past letters, we have refuted the conventional story that loose Japanese money is poised to flood global financial markets. The evidence of very weak monetary growth proves that the BoJ is, to use the old phrase, "pushing on a string." It well may be that Japan's economy currently is staging a tentative recovery. This should come as no great surprise, given the monstrous scale of fiscal reflation. Monetary easing has little or nothing to do with it. But Japan's rock-bottom short-term interest rates have created an extremely imbalanced situation in the global financial markets, carrying tremendous risks for both the dollar and global bond markets.

JAPAN: THE SEEDS OF NEXT UPHEAVAL

If the drastic weakening of the yen has created the impression that the desired capital outflows at long last are materializing, it is an utter mistake. When the BoJ slashed its money-market rate to a new historic low of 0.5% in September, the idea, of course, was to prod Japanese investors into higher-yielding foreign investments, helping to drive down the stubbornly strong yen.

But the rate cut proved a complete failure in this respect. Contradicting the declarations of foreign analysts, Japanese sources report that many Japanese institutional investors view the weak yen as both artificial and temporary, and are buying domestic bonds. On balance, they were net sellers of foreign stocks in 1995, though on a modest scale. Purchases of foreign bonds did take a upward leap in the middle of last year, but the surge proved temporary.

The statistics themselves may mislead. Nomura Securities, the largest retailer of foreign paper in Japan, suspects the Bank of Japan was the true buyer behind these supposedly private purchases of foreign bonds. The explanation is fairly simple: When the BoJ invests the proceeds of its dollar-buying interventions in assets with maturities of over five years, those assets are not counted as part of Japan's official foreign-exchange reserves. Rather, they appear on the books as private transactions. Official reserves soared from $125 billion to $182 billion last year. We can only imagine how much was added to the BoJ's portfolio of U.S. Treasuries under the guise of private purchases.

In hindsight, we can see that the slashing of Japanese short-term rates to unprecedented levels had two major effects on Japan's capital account. Both foreshadow serious future trouble.

One effect of the BoJ's move was to trigger a buying spree by foreign investors, who snapped up Japanese stocks on the assumption that extremely cheap money was bound to set the financial markets booming. During the second half of 1995, foreigners bought a total of more than $40 billion worth of Japanese stocks. But pessimistic Japanese investors did the opposite, continuing to liquidate their own equity holdings.

The second effect was a stampede of international yield-curve speculators into the Japanese money market, drawn by the irresistible lure of cheap yen financing. Borrowed yen could be swapped for dollars or European currencies, which could then be invested in the corresponding higher-yielding government bonds. In short, foreigners took over as Japan's capital exporters. Or, to put it more correctly, they began exporting hot, borrowed money from Japan on a massive scale. Yen-dollar transactions appeared to account for the biggest chunk of these transactions.

The exact amounts committed to this leveraged play are unknown. But with yield spreads between short-term Japanese rates and medium-term foreign notes amounting to 500 basis points or more, it's clear the game quickly acquired an immense popularity. Hedge-fund operators and other speculators around the world hurried to feast upon what appeared to be an opulent free lunch.

Importantly, this massive speculative orgy played a crucial role both in weakening the yen and in helping drive global bond prices (and hence stock prices) to dizzy new heights. It was exactly analogous to the U.S. yield-curve playing frenzy of 1993, which ultimately led to the global bond meltdown of 1994.

The 1993 bubble primarily involved using borrowed short-term dollars to finance positions in longer-term dollar bonds. But now, international speculators have taken the game a step further by crossing currencies, thus adding yet another element of risk to the equation.

The dangers are threefold. This latest version of the carry trade will blow up instantly if any one of three things happens: If the BoJ begins to raise its short-term rates; if long-term rates rise in the recipient countries, causing capital losses on bond holdings; or if the yen rises against the dollar.

Of the many speculative bubbles that have developed in the world financial markets in recent years, this one is by far the most vulnerable, and the most dangerous, since it embroils both the bond and currency markets. The risks for the yen-dollar rate are particularly catastrophic. Once the bubble bursts – and it is only a matter of time before it does – the wholesale dumping of Treasuries will be joined by the wholesale dumping of dollars.

Recent tremors in the bond market may be warnings of the approaching earthquake. The dollar's slide against the yen, and the fears sparked by the rise in the gold, appear to have blasted some yen-dollar speculators out of their positions. It remains to be seen how many more positions will have to be unwound when the selling climax arrives.

THE VULNERABLE DOLLAR

In our recent letters, we have warned of a transitory period of dollar firmness. Yet our secular view remains unchanged: We continue to see the dollar falling and the DM, the Swiss franc and the yen rising. But, within that trend, there can be quite large and long-lasting swings the other way, depending on short-term changes in market sentiment and monetary conditions. Waves of dollar bullishness, interrupting the greenback's long-term downtrend, have come and gone.

For us, the astonishing thing about the recent wave of dollar bullishness is how quickly it burned out, despite the bad economic news from Germany. Clearly, there was heavy speculation on a prolonged rise of the dollar. In the futures market, bullish players held near-record long positions in the greenback. Yet the rally collapsed, leaving the international currency trading community shellshocked and aghast.

As we previously predicted, speculation on a stronger dollar was fueled by surprisingly bad news out of Germany, warning of rising unemployment and the growing risk of recession, compared with a generally rosy view of the economic situation in the United States. The fact that the U.S. economy also was deteriorating sharply was concealed by the federal government shutdown, which largely cut off the flow of statistical data to the markets.

A key argument of the dollar bulls was that the Bundesbank would be under enormous political pressure, both domestic and foreign, to ease too fast and too much. We, on the other hand, held that with the repo rate at 3.3%, and the discount rate down to 3%, there was precious little room for German rates to move still lower. Now the true picture is becoming clear. At 5%, U.S. short-term rates clearly have much further to fall. Indeed, the mounting evidence of economic weakness suggests that U.S. rates may in fact fall more than German rates in coming months.

LOOMING RECESSION

The dollar, of course, is highly accident prone, as last year's Mexican peso crisis revealed. At present, the greenback is particularly vulnerable to the bursting of the yen-dollar bond bubble. Yet we prefer to focus on the cyclical and fundamental factors. From this point of view, the most important issue is the near-term performance of the U.S. economy. Soft landing or recession – that's the key question. We see a high probability of recession.

Admittedly, it is hard to tell how much of the recent declines in production, retail sales and other aggregates are the consequence of special factors, such as bad weather or the government shutdown, and how much they reflect the underlying state of the economy. Eventually, normal weather will spur a surge of catch-up activity, which undoubtedly will make the overall picture appear better than it is in reality.

But our expectation of a recession this year is strongly influenced by the fact that all major demand components weakened sharply in the second half of 1995. What prevented the near-stagnation of the U.S. economy were two short-term, unsustainable trends: a substantial improvement in the U.S. trade deficit, and a surge in automobile inventories.

While autos are sure to become a negative for growth, foreign trade is the joker in the deck. Most of the trade improvement results from falling imports, which reflect weakened domestic demand. Exports, meanwhile, maintain their upward trend, albeit at a slower rate. A recession would dampen imports still further, but at the same time U.S. exports will be hit by the unfolding recession in the rest of the world, and particularly in Europe and Canada. All told, more than 65% of U.S. merchandise exports go to countries that are either in, or on the verge of, recession. Economic growth on the Asian mainland also is slowing. All too soon, therefore, a new deterioration of the trade balance may add to the U.S. economy's weakness.

The crucial point: A U.S. recession will imply easier money relative to Germany and Japan. In our opinion, a mammoth U.S. current-account deficit – currently running at a $165 billion annual rate – combined with looser monetary policy is a sure harbinger of the next major decline in the dollar.

THE TROUBLING U.S. CAPITAL ACCOUNT

Fed easing would tend to hit the dollar primarily by weakening the U.S. capital account, which in any case makes for strange reading. During the first nine months of 1995, the United States had record-high capital inflows of $325 billion, of which $100 billion came from foreign central banks. Of the remaining $225 billion, purchases of U.S. securities (mostly bonds) accounted for $154 billion.

That stupendous sum unquestionably played an important role in stoking the bull run in U.S. bonds. But why didn't it provide more support for the dollar? The short answer is that record capital inflows were matched by record-high capital and money outflows, amounting in the first nine months of last year to $218 billion. Add to this the huge current-account deficit, and you can understand why the dollar remained weak despite the surge in gross capital inflows.

Where does all this leave the dollar? In the long run, we remain bearish. The most important negative fundamental for the dollar is the huge U.S. current-account deficit. American economists generally belittle it, arguing

that it is rather small relative to U.S. GDP. This is true, but it still is far too large to be swallowed by the rest of the world's capital markets. That's the basic reason why it can only be financed through permanent, massive dollar purchases by foreign central banks.

Without those purchases, the dollar would have collapsed long ago, forcing the Fed into a savage monetary tightening. Seen in this light, any dollar strength is artificial. True dollar strength would require a substantial narrowing of the U.S. current-account deficit, and that simply is not in sight. While the trade balance with Japan is improving, deficits with China and the other East Asian countries are mounting just as fast.

The eternal bull point about the dollar is that it is grossly undervalued and super-competitive, compared to a grossly overvalued and uncompetitive DM. If this is a valid argument, one can only wonder why the U.S. economy is stuck with a current-account deficit that has reached $165 billion, while the allegedly uncompetitive German manufacturing sector has been running a surging trade surplus, jumping from DM 21 billion in 1991 to an estimated DM 80 billion in 1995. Indeed, the German current account itself would be in healthy surplus if not for soaring service and transfer payments, and massive annual payments to the European Union's subsidy system.

EVERY BUBBLE EVENTUALLY BURSTS

We wonder what has shocked investors more: the dollar's sudden reversal, or the abrupt global plunge in bond prices. Since these developments have flown in the face of all the forecasting models, the speculators still don't have a clue about what has gone wrong.

To our minds, both the bond slump and the dollar's renewed decline should be seen as the natural consequence of past speculative excesses. Given the enormous leverage now embodied in the bond and currency markets, even a modest unwinding of speculative positions can have a devastating effect on prices.

Whether the recent downturn marks the beginning of the end for the bond bull market is less clear. As we mentioned earlier, market participants seem to be recoiling from the prospect that faster economic growth later this year will bring an upturn in commodity price inflation. We think such a reaction is entirely unwarranted. The odds overwhelmingly favor slower growth, if not outright recession, in 1996.

But it should be stressed again that every speculative bubble portends its eventual bursting. The speculative flows now supporting the global bond rally simply are not sustainable in anything but the short run. In that regard, we think it important to note the ominous deterioration of those funding sources in recent years.

In the early 1990s, yield-curve playing by U.S. banks and nonbank financial institutions provided the crucial financing for the first stages of the bond rally. In 1992 and 1993, mutual funds, hedge funds and individual speculators rushed to emulate the banks, only to be badly bruised in the 1994 bond meltdown. Now, the health of the U.S. bond market is deeply dependent on the willingness of international speculators to place leveraged bets across currencies on a massive scale. In the parlance of the markets, bonds are moving steadily from strong hands to weaker ones.

Every bubble has one and the same cause: monetary overexpansion. But any unforeseeable trivial event may suddenly break it. Recent rumors that South African president Nelson Mandela was ill sufficed to prick an enormous speculative bubble in the high-yielding (around 14% for short-term deposits) South African rand – a bubble also financed by cheap yen. Within days, the rand fell 8% against the dollar.

As we seek an explanation for the recent global bond slump, it seems clear the market's immediate problems are related to the extraordinary low level of Japanese short-term rates. Talk of an impending global upturn, plus a tentative acceleration in the Japanese economy, forced at least some speculators to confront the thought that the BoJ isn't likely to leave the discount rate at 0.5% forever. This, in turn, spurred the unwinding of highly leveraged positions, involving the dumping of dollars and bonds.

So far, the damage from this unwinding appears to have been limited. But as we have often stressed and explained, all that is required to crack a bull market is that the inflow of new money stop. In the 1920s, old timers spoke of "bicycle markets" – as long as the vehicle moves forward, the rider easily keeps his balance. But as soon as forward motion stops, the bicycle promptly falls over, throwing the rider to the ground. The bicycle, in this case, plainly is slowing down.

BUBBLES AND THEIR AFTERMATH

History shows the overwhelming importance of identifying asset bubbles as early as possible. Above all, central banks should be ever alert to the dangers of creating them, because they inevitably spell later disaster.

The textbook case of modern times is Japan, where a once-thriving economy has been savaged by a monstrous debt-driven asset bubble. The culprit: the BoJ's desperate attempt to fend off an undesired appreciation of the yen with a policy of protracted, excessive monetary ease in the late 1980s. The result was a boom in real estate and stocks to beat all booms. The rest of the world watched in admiration and awe.

The disastrous final result is well-known: bad loans running into the trillions of yen, a virtually paralyzed banking system, a collapse in business fixed investment, and an economy in its fifth year of near stagnation.

The most frightening aspect of this experience, in our view, is that it was a case of rampant inflation, but one concentrated in just two asset categories. What misled the BoJ and most others was the fact that consumer prices didn't show a trace of inflation. It took years for the BoJ and the rest of the world to wake up to the possibility of a kind of inflation not foreseen in contemporary standard textbooks.

Since then, many expert papers on the bubble phenomenon have been published, in particular by the International Monetary Fund. To our great amazement, not one of them addresses the crucial distinguishing feature of a bubble, the one which permits its early detection and prevention.

For good reason, just this question has been a prominent topic in these letters for some time. Actually, there is a straightforward gauge for the identification of an inflationary bubble. It lies in the sources of the funds flowing into the asset markets, and begins by comparing them with available domestic savings. In principle, there always are just two separate sources: savings proper, on the one hand, and various kinds of inflationary processes, on the other. Putting it into the simplest formula: Any flows of funds into debt and equity markets in excess of current savings essentially are of an inflationary nature. The resulting boom qualifies as asset inflation – in other words, a bubble.

Take, for example, the recent speculative rampage in the global bond markets financed with cheap, borrowed yen. Even to people with only scant knowledge of monetary matters, it should have been obvious that this mania, involving as it did large-scale international credit creation, was most conspicuously a bubble.

Generally speaking, such inflationary money flows have two particular characteristics: First, they result either from money creation or from a rise in the velocity of money circulation; secondly, the purchases they finance are made to exploit interest-rate differentials, or to reap short-term capital gains. What's wrong with these characteristics? The inflationary money flows simply are not sustainable in the long run. Meanwhile, they tend to drive asset prices to unsustainable, dizzy heights. Together, these two negatives make for the later, inevitable crash.

Considering all the circumstances, we assume the yen-dollar carry trade now has dried up, at least in the sense that henceforth it will push little or no new money into the global bond markets. If true, it would mark the death knell for the bull run in bonds. By implication, it would be equally bearish for the dollar.

The lesson should be clear: The BoJ's cheap-yen policy provided only a transitory solution to the deep structural problems facing the U.S. bond market and the dollar. While rock-bottom Japanese rates played a crucial role in 1995's global financial recovery, they did not do so by restimulating long-term capital exports by Japanese institutional investors, as the central bankers clearly hoped. Rather, they created powerful but unsustainable bubble effects in the bond and currency markets. Meanwhile, the stimulative effects on Japan's economy appear quite disappointing.

THE LIQUIDITY CONUNDRUM

Ignoring the setback in bonds, the U.S. stock market continues to forge ahead, corroborating once again its great capacity to disregard anything negative and to focus only on the positive. In this case, the widely celebrated good news is the growing prospect of impending further rate cuts at the short end by the Fed and the other central banks.

Looking at the booming stock markets, we are preoccupied with the liquidity implications. Here is the greatest financial boom in world history, considerably bigger than even the bull market of the 1980s. Yet money – in other words, liquidity – growth is far weaker than at any time since the Great Depression. What are we to make of that?

The bullish story is that low inflation has fundamentally changed the valuation paradigm. As investors no longer worry about inflation's erosive effects, they are willing to pay more for a dollar of future earnings. We have little quarrel with that side of the explanation, but it still leaves the crucial, pertinent question: Given the low rates of money growth, what is providing the purchasing power driving the boom? We have identified four major sources:

- A dramatic shift – particularly in the United States and the other Anglo-Saxon countries – in the supply of credit away from banks and towards nonbanks and the capital markets. As only bank lending involves money creation, this implies lagging money growth relative to debt growth.

- An unprecedented shift in the spending of money towards financial assets at the expense of goods, services and tangible assets. As a result, inflationary pressures have been concentrated in the financial asset markets, as against very subdued inflation in consumer and producer prices. This shift in spending presumably has a variety of reasons, including economic, financial and demographic structural changes.

- An equally unprecedented shift by investors out of the total existing money stock (bank balances and short-term money assets) and into securities. This inflates the demand for securities without changing the money stock. Among the old economists, this decline in the demand for money used to be labeled as "a reduction in liquidity preference" – or "dishoarding."

- Heavy leveraging through futures and other derivatives markets. Buying pressure in these markets is transferred to the cash markets through the actions of dealers and counterparties seeking to hedge their derivatives exposure.

Ignoring the rampant inflation in the financial markets and focusing narrowly on the performance of the conventional price indexes, there is a widespread opinion that central banks have done an excellent job. William McDonough, the president of the Federal Reserve Bank of New York, reflected this view in a recent speech, in which he declared: "I am convinced that much of our success in containing inflation in recent years reflects monetary policy actions that preempted inflationary pressures before they actually showed up in general prices."

We are unable to share this smug belief in the superior wisdom of today's central bankers. For some years, we have argued that as far as consumer and producer prices are concerned, the inflation danger has receded considerably. But our reading of the reasons is entirely different from Mr. McDonough's.

In our view, the basic cause for the global disinflationary trend is the fact that years of monetary and fiscal mismanagement have robbed the economies of the industrial countries of their former growth dynamics, which tended to foster price inflation. Broken growth has subdued inflation, not the magic of central banks.

In a world where most enterprises prefer acquisitions to expansion, essentially at the expense of long-term economic growth, inflation tends to shift to asset prices. The slowing of growth, in turn, has broken wage inflation and the wage-price spiral. Against this backdrop, the leverage of monetary policy over the real economy has declined, even as its power over the financial markets has increased.

The facts speak for themselves: In many countries, including the United States, price inflation has not been a serious threat for years, even though monetary policy has been extremely loose at times. Given lurking, subpar economic growth, the financial markets have become inflation's sponge. How long can this financial bubble last? Normally, it would be pricked by a monetary squeeze implemented by central banks in response to an overheating economy and accelerating consumer price inflation. But looking for poor economic growth in the long run, we regard the inflation issue as dormant, at least for the time being.

In an odd way, our views coincide with the rosy scenario of the raging bulls, who bet that a weakening economy is the infallible harbinger of more financial bullishness. Since numerous investors readily subscribe to this postulate, they act and buy, validating it.

LEVERAGED MARKETS BECOME ILLIQUID MARKETS

Where we vehemently part company with the bulls, however, is over the liquidity issue. The apparently endless stampede of investors into bonds and stocks, either with borrowed money or out of their liquid money balances, has frightening liquidity implications in the long run, foreshadowing the inevitable future crash.

Panic is now programmed into the markets by short-term speculative positions running into the trillions of dollars around the world. The world financial system has virtually unlimited leverage and borrowing potential to accommodate its bullish visions. These visions could soar even higher before the bubble bursts. Driven by the conviction that worried central bankers will pour more monetary oil onto the flames, investors could easily drive the Dow to 6,000 or even higher. While watching for the coming crisis, we wouldn't bet against the bulls as yet.

While the torrents of money flowing into U.S. stocks may bear all the hallmarks of bubble sources, these flows seem indefatigable for the time being, defying even the recent setbacks in the bond market. It is impossible to say what may stop the stampede into stocks, save for a savage monetary squeeze, which is not in the cards.

Still, we have to warn: Don't be fooled by the Wall Street mantra that these bull markets have sound fundamentals and are driven by excess liquidity. Both statements are false. The current boom is driven neither by excess liquidity nor by excess savings, but rather by a panoply of leveraging devices. In essence, leveraged markets become illiquid markets.

And what of the legitimate savers, those who are plowing their own hard-earned money into the market? Their peril can be seen in the fact that at time when U.S. stock dividends are at record lows, Americans are using the stock market as their number-one savings vehicle. This kind of mania can only end badly.

In 1989, the Bank of Japan pricked the nation's land and stock bubble – even though consumer price inflation was close to zero, because the BoJ's governor, Yasushi Mieno, wanted to puncture it before it burst of its own accord from an even more extreme level of overvaluation. But it was already too late to stave off financial catastrophe. This example should be kept in mind by every investor tempted to play the current bull market.

Is there a chance the Fed will follow the BoJ's lead, and deflate the bubble on Wall Street? We think it unlikely. We doubt very much the Fed would ever act against asset inflation as long as wages and consumer price inflation appear in check. Financial speculators everywhere have one true and faithful friend in this world: The Federal Reserve.

At the moment, there seems to be scant concern in the markets about the threat of recession. Given an almost mythical belief in the Fed's powers, and a general perception that the booming financial markets reflect a surfeit of liquidity, the predominant view seems to be that any further Fed easing will promptly revive economic growth.

Yet the Fed itself sounds noticeably more worried about recession than it did even a few weeks ago. In his recent testimony to Congress, Fed chairman Alan Greenspan warned that the U.S. economy has hit "a significant soft patch." He put the odds of avoiding recession at "better than 50-50." Well, to us, that sounds a lot less upbeat than any of his prior pronouncements on this issue.

As we explained earlier, we do expect that protracted, sluggish economic growth, if not an actual recession, will keep inflation in check. This will tend to encourage ever greater speculation. But the greater the excesses, the worse the inevitable, final crash. Clearly, the recent slump in long-term bonds had little to do with inflation fears, but everything to do with unexpected changes that upset the universal assumptions behind the wave of yen-financed speculation.

One popular view holds that sooner or later, investors and speculators will move out of overvalued financial assets and into either current expenditure or tangible assets, such as gold, real estate, etc. This is an utterly delusive concept. It is always possible to switch unlimited amounts out of money balances and into illiquid, marketable assets. But any reverse movement of similar strength – out of bonds or stocks, into money – essentially would end in crash and panic.

The point is that an investor can liquify his marketable investments only if there is someone willing to surrender an existing cash balance in exchange. If the balance of sellers is not matched by buyers, the result is plunging asset prices. Market values simply disappear, while the existing money stock is left unchanged. The net effect is a collapse in the perception of liquidity, breeding over time a desire for rising liquidity, and a mad scramble for cash.

To us, the current party in the financial markets looks suspiciously like the final blowoff in Japan during 1989, and the earlier demented frenzy on Wall Street in 1929. Then, as now, easy money was the problem, not the solution.

CONCLUSIONS

The dollar's bull run is already over. Only new, record-high interventions by the Bank of Japan have prevented a catastrophic slump. Fundamental, monetary and technical considerations argue for a continued decline. Any minor rallies are almost certain to falter. Endangered by the dollar's sudden weakness, the yield-curve players who have ramped up the U.S. bond market with cheap, borrowed yen are running for cover. Bond yields have jumped; they easily could jump higher still.

At this critical point, we think it absolutely crucial to understand that rising yields would not be inconsistent with faltering economic growth in the United States and elsewhere. Speculative flows have driven global bond prices far beyond what can be justified by the fundamentals – particularly in the light of the heavy demands on world savings posed by the giant U.S. current-account and budget deficits.

By giving the central banks room to slash rates, weakening economies may stave off disaster in the bond markets. But lower rates may already be discounted in the market. If so, a rise in real, after-inflation bond yields is possible, even likely. Obviously, for the stock markets, such a combination of recession and higher real yields would constitute the worst of both worlds. But given the current euphoria, we wouldn't dare to assume that the market has reached its peak.

It's time to put safety first. We still see a financial slump, if not a crash, in the future. The only safe havens are the short and medium-term bonds of the hard-currency countries: Germany, Austria, Switzerland and the Netherlands.

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